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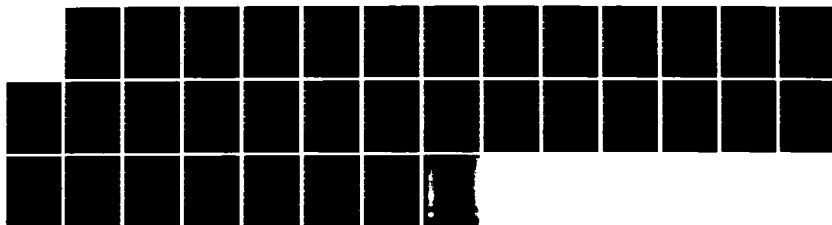
DEPARTMENT OF DEFENSE'S FIRST-YEAR IMPLEMENTATION OF
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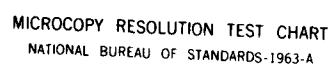
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Report To The Secretary Of Defense

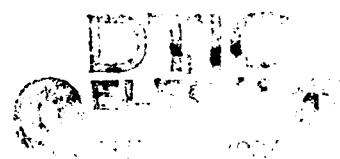
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Department Of Defense's First-Year
Implementation Of The Federal
Managers' Financial Integrity Act

GAO conducted a review of 22 federal agencies' efforts to implement the Federal Managers' Financial Integrity Act of 1982. The act was intended to help reduce fraud, waste, and abuse across the spectrum of federal government operations through annual agency self-assessments of their internal controls and accounting systems.

This report highlights the progress made and problems encountered by the Department of Defense in its first year of experience with this new act. The report focuses on Defense's efforts to evaluate internal controls, review accounting systems, and improve the evaluation processes as a result of identified problems.

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GAO/NSIAD-84-98
MAY 1, 1984



UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

B-202205

The Honorable Caspar W. Weinberger
The Secretary of Defense

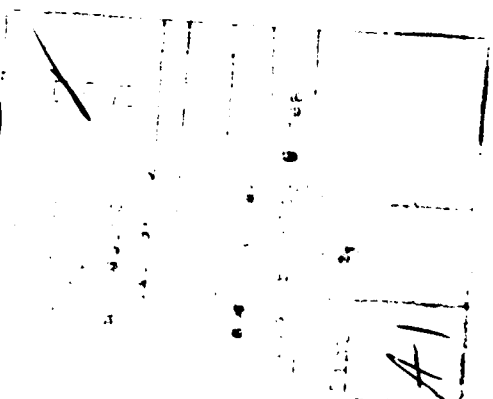
Dear Mr. Secretary:

This report summarizes the results of our reviews of the Department of Defense's (DOD's) efforts to implement and comply with the Federal Managers' Financial Integrity Act of 1982. This act affects executive agencies including all services, agencies, and offices within DOD. These reviews were part of a governmentwide assessment of the act's first-year implementation.

Our reviews of DOD's implementation were performed at the Departments of the Army, Navy, and Air Force; the Defense Logistics Agency; and the Defense Mapping Agency--five of the 24 reporting centers established by DOD. We are issuing separate reports to these five centers (see app. III) and are providing copies to your office. We also reviewed the policies and procedures established by your office in response to the act.

The act requires continuing evaluations and an annual statement to the President and to the Congress concerning the adequacy of each executive agency's systems of internal accounting and administrative controls. It also requires each agency to report annually on whether its accounting systems conform to the principles, standards, and related requirements prescribed by the Comptroller General of the United States. We believe full implementation of the act will enable the heads of executive agencies to identify their major internal control and accounting problems and improve controls essential to the development of effective management control systems, as well as a sound financial management structure for their agencies.

Further details of the act and our objectives, scope and methodology are in appendix I.



OBSERVATIONS

In your December 28, 1983, statement to the President and the Congress, you reported broad areas in which internal control weaknesses had been corrected or corrective actions were required. You also reported on deficiencies in DOD's accounting systems. Additional information on the statement is in appendix I. Appendix II provides details on the areas having internal control weaknesses.

We found that DOD has made progress in complying with the requirements of the act. DOD published its internal control directive (Directive 7040.6) on March 24, 1982, in response to Office of Management and Budget Circular A-123. The directive assigns responsibility to reporting center heads for developing and implementing plans for vulnerability assessments and internal management control reviews and for responding to reporting requirements. All centers scheduled and completed their assessments by December 1982. Based on these assessments, the centers prepared plans for conducting internal control reviews.

In spite of the progress, some problems and delays have been encountered which have affected the implementation of fully satisfactory programs DOD-wide. Many of these have DOD-wide implications; some are unique to specific reporting centers. For example, the DOD-wide problems include (1) early DOD-wide guidance for making vulnerability assessments excluded such evaluation factors as budgeting and reporting practices, and program age and life expectancy; (2) persons involved in the internal control process at the five centers reviewed needed additional and/or better training which would provide practical instructions on how to perform evaluations; and (3) some reporting centers did not include all organizational and/or functional elements when dividing the centers into assessable units. Moreover, one nonappropriated fund organization--the Army and Air Force Exchange Service--did not comply with the act because the Exchange Service decided that it was not subject to the act's requirements. However, the Exchange Service's large volume of sales (\$4.3 billion in fiscal year 1982), and its recent history of weak internal controls make it vulnerable to loss, waste, unauthorized use or misappropriation of assets. These items and others are discussed further in appendix I and in our reports on the individual reporting centers.

DOD has drafted a revision to its internal control directive. The revision will require reporting centers to establish a formal follow-up system to record and track (1) deficiencies disclosed by any source, (2) scheduled corrective actions, and (3) established completion dates for those

corrective actions. The reporting centers we visited have developed or are in the process of developing such systems. We plan to closely monitor progress in this area in the future.

We also found that the military departments and the Defense Logistics Agency made determinations on accounting systems compliance with the Comptroller General's accounting principles and standards based on the experience, knowledge, and observations of accounting officials. The Defense Mapping Agency based its report on the determinations made by the Air Force because it uses the Air Force's accounting system software. DOD plans to provide additional guidance for evaluating its accounting systems. The guidance will include assigning responsibilities for documenting accounting system designs, testing systems in operation, and tracking reported accounting system problems.

CONCLUSIONS

In summary, DOD has made progress in implementing the Financial Integrity Act. In order to have a fully satisfactory program departmentwide, improvements are needed in certain areas, some of which are highlighted in this report. Details of these and other areas needing attention are presented in our reports to the heads of the five reporting centers we reviewed this year.

DOD has recognized the need to make improvements in its internal control evaluation process and has taken or plans to take corrective actions in each of the areas where we identified weaknesses. We believe that these corrective actions will enhance DOD's efforts to comply with the act in the future and provide the basis for more meaningful statements regarding DOD's internal controls.

AGENCY COMMENTS

In commenting on a draft of this report, DOD concurred with our findings and proposals. (See app. IV.) DOD also described its planned and completed actions to correct the problems discussed.

One issue addressed in a draft of this report, which required consideration by your office, was the matter of whether the Army and Air Force Exchange Service is subject to the act. In a letter dated March 8, 1984, DOD's General Counsel office concluded that nonappropriated fund activities, including the Exchange Service, are not covered by the act. We had proposed that, as a matter of policy, you (1) direct the Army and Air Force Exchange Service to follow the provisions of the act and

(2) assign permanent responsibility for the Exchange Service's internal control evaluation process to either the Secretary of the Army or the Secretary of the Air Force.

In a letter dated March 27, 1984, DOD agreed to revise its internal control directive to include nonappropriated fund instrumentalities as a matter of policy. (See app. IV.) DOD also requested that the Secretaries of the Army and Air Force agree to a permanent assignment of responsibility for the purpose of fulfilling the requirement of the directive in respect to the Exchange Service by the close of fiscal year 1984. We believe that this action is satisfactory and plan to continue monitoring the Exchange Service's implementation of the directive.

As a result of DOD's planned and completed corrective actions, we are not making any recommendations in this report or in our reports to center heads.

We are sending copies of this report to the Director, Office of Management and Budget; the Chairmen, Senate Committees on Governmental Affairs, Appropriations, Armed Services, and the Budget; and the Chairmen, House Committees on Government Operations, Appropriations, Armed Services, and the Budget. We are also sending copies to the Secretaries of the Army, Navy, and Air Force; and the Directors, Defense Logistics and Defense Mapping Agencies.

We appreciate the courtesy and cooperation Defense personnel extended to us during our reviews.

Sincerely yours,



Frank C. Conahan
Director

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ABBREVIATIONS

ADP	Automated Data Processing
DOD	Department of Defense
GAO	General Accounting Office
OMB	Office of Management and Budget

DOD'S FIRST-YEAR IMPLEMENTATION OF THE FEDERAL
MANAGERS' FINANCIAL INTEGRITY ACT

THE FINANCIAL INTEGRITY ACT

The Congress, in 1982, enacted the Federal Managers' Financial Integrity Act, 31 U.S.C. 3512(b) and (c), in response to continuing disclosures of waste, loss, unauthorized use, or misappropriation of assets across a wide spectrum of government operations which were largely attributable to serious weaknesses in agencies' internal controls. The act was designed to strengthen the existing requirement of the Accounting and Auditing Act of 1950 that executive agencies establish and maintain systems of accounting and internal control to provide effective control over and the accountability for all funds, property, and other assets for which the agency is responsible, 31 U.S.C. 3512(a)(3).

We believe that full implementation of the Financial Integrity Act will enable the heads of federal departments and agencies to identify their major internal control and accounting problems and improve controls essential to the development of an effective management control system and a sound financial management structure. To achieve this, the act requires:

- Each agency to establish and maintain its internal accounting and administrative controls with the standards prescribed by the Comptroller General, so as to reasonably ensure that: (1) obligations and costs comply with applicable law; (2) all funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (3) revenues and expenditures applicable to agency operations are recorded and properly accounted for.
- Each agency to evaluate and report annually on internal control systems. The report is to state whether agency systems of internal control comply with the objectives of internal controls set forth in the act and with the standards prescribed by the Comptroller General. The act also provides for the agency report to identify the material weaknesses involved and describe the plans for corrective action.

- Each agency to prepare a separate report on whether the agency's accounting systems conform to principles, standards, and related requirements prescribed by the Comptroller General.
- The OMB to issue guidelines for federal departments and agencies to use in evaluating their internal accounting and administrative control systems. These guidelines were issued in December 1982.
- The Comptroller General to prescribe standards for federal agencies' internal accounting and administrative control systems. The Comptroller General issued these standards in June 1983.

The Comptroller General's presentation at the September 29, 1983, meeting of the assistant secretaries for management outlined his expectations for agency efforts to report on conforming accounting systems to the Comptroller General's principles and standards (section 4 of the act). Recognizing that not all agencies had begun work to implement section 4, the Comptroller General emphasized the following constructive actions which could be taken to provide building blocks for future years' implementation:

- Organize for completing accounting systems evaluations and issue needed written policies and procedures.
- Inventory accounting systems.
- Identify prior reported system deviations.
- Rank the systems according to the materiality of potential deviations from our accounting principles and standards.
- Initiate reviews of systems.
- Plan for the first-year report.

This report is one of GAO's 22 reports on federal agencies' efforts to implement the act.

IMPLEMENTING THE ACT

In order to implement the act departmentwide, DOD was divided into 24 reporting centers. Each center was required to implement an internal control program and report to the Secretary of Defense on the adequacy of its systems of internal

accounting and administrative controls. The centers we reviewed also reported on whether their accounting systems conformed to the principles, standards, and related requirements prescribed by the Comptroller General of the United States. The center reports provided the basis for the Secretary of Defense's December 1983 statement to the President and to the Congress on the adequacy of DOD's internal controls and the extent to which its accounting systems conform to the required principles and standards.

The DOD Inspector General made independent assessments of Defense agencies' internal controls and accounting compliance evaluation processes and reporting. At the suggestion of the Deputy Secretary of Defense, the Auditor Generals of the military departments made assessments for their respective departments. The Inspector General reported these results to each Defense agency and the combined assessment results, including those of the Auditor Generals, to the Secretary of Defense.

The Inspector General recommended that the Secretary of Defense's December 1983 statement be qualified to acknowledge that the internal control process was not complete and consistent within the department. The Inspector General stated in the report that DOD had taken reasonable and prudent action to implement the accounting systems reporting provisions of the act and had established a reasonable reporting base for the initial report.

INTERNAL CONTROLS PROCESS

In accordance with the act, OMB has established guidelines for agencies' evaluations of their systems of internal accounting and administrative control. These guidelines provide a basic approach to evaluating, improving, and reporting on internal controls. OMB recommends the following process as an efficient, effective way to perform the required evaluations:

- Organize the internal control evaluation process.
- Segment the agency to create an inventory of assessable units.
- Conduct vulnerability assessments to determine the risk of waste, loss, unauthorized use, or misappropriation.
- Review internal controls.

--Take corrective actions.

--Report on the adequacy of internal controls and plans for corrective action.

We observed several problems which have affected the implementation of fully satisfactory programs DOD-wide. The problems largely stemmed from different guidance provided at various times. OMB issued Circular A-123 in October 1981, establishing a governmentwide internal controls program. The circular, which was the predecessor of the act, was implemented by DOD in March 1982. The act was subsequently approved in September 1982, and OMB's guidelines were issued in December 1982. Consequently, much of DOD's work took place earlier in 1982 before the act was passed and OMB guidelines, required by the act, were available.

The following problems were identified as a result of our reviews this year. Many of these have DOD-wide implications; some are unique to specific reporting centers.

--Early DOD guidance for making vulnerability assessments included about half the evaluation factors subsequently prescribed by OMB. DOD did not include such factors as budgeting and reporting practices, ADP considerations, degree of centralization, and program age and life expectancy. We believe that evaluation of all factors affecting a program improves the accuracy of vulnerability assessments and, thus, improves the overall internal control process.

--Persons involved in the internal control process at the five centers reviewed need additional and/or better training. For example, the Army's early training was limited mainly to orientation sessions for persons involved in the internal controls evaluation process. Subsequent training did not provide practical instruction to line managers on how to perform the actual evaluations. We recognize that tight time constraints during the first year reduced the opportunities for training the managers involved in the process. We believe that training is an excellent means of disseminating program expectations and an important factor in achieving consistency in the evaluation process.

--Some reporting centers did not include all organizational and/or functional elements in dividing their centers into assessable units. For example, the Defense Mapping Agency's first-year process excluded the Hydrographic/Typographic Center's field offices, motorpool, book

library, silver recovery functions, and minicomputers. We believe that all programs, functions, and activities should be considered under the act.

- Problems were encountered with vulnerability assessments. Generally, the vulnerability assessments were inadequately and/or inconsistently performed within the centers. In one case, the Defense Logistics Agency did not provide specific guidance to field activities for completing vulnerability assessments. This resulted in inconsistencies ranging from one activity not performing vulnerability assessments at all to another activity performing and documenting its assessments. We believe adequate and consistent assessments are important because they provide the basis for managers to determine which programs and activities are highly susceptible to risks of waste, loss, and unauthorized use of assets.
- Generally, reporting centers inadequately and/or inconsistently documented vulnerability assessments and internal control reviews. For example, the Navy required little vulnerability assessment documentation from its components and some that was required was not submitted. This resulted in inconsistent documentation among Navy's components with very vague descriptions of the rationale supporting the assessments assigned. We believe that documentation of vulnerability assessments and internal control reviews is important to provide managers with an understanding of how the vulnerabilities were determined, the internal controls were evaluated, and the actions proposed were considered.
- All centers reviewed had problems concerning ADP general and application controls¹ in their evaluations. For example, the Air Force's internal control reviews generally did not consider ADP controls in heavily automated functions and some Army-wide automated systems were not comprehensively reviewed during their first-year evaluations. Because ADP is an integral part of management and accounting systems, we believe that it is imperative to consider ADP general and application controls as part of the internal control evaluation process.

¹General controls apply to the overall management of the ADP function and affect most ADP hardware and application software systems. Application controls are unique to each software application system and are intended to assure the quality of data origination, input, processing, and output.

--The Army and Air Force Exchange Service is a joint command, with management responsibility alternating between the Departments of the Army and the Air Force. The Army and Air Force Exchange Service, based on its General Counsel's opinion, decided that it was not subject to the act's requirements to report on its internal controls. Consequently, the Exchange Service used its own process for evaluating internal controls and reported only to its Board of Directors. The Exchange Service's evaluation process, however, did not meet the requirements of OMB or Air Force guidelines. The Air Force did not consider the Exchange Service to be included under the act because it is a nonappropriated fund activity. The Navy, however, included its exchange system in its internal control program. The Army and Air Force Exchange Service's large volume of sales (\$4.3 billion in fiscal year 1982), and its recent history of weak internal controls make it vulnerable to loss, waste, unauthorized use, or misappropriation of assets. For example, since 1977, there have been 66 convictions for offenses such as bribery, accepting gratuities, and tax evasion in Exchange Service-related prosecutions. We believe that as a matter of good management policy the Exchange Service should be directed to comply with provisions of the act.

--The Navy, after completing reviews of the Navy-wide highly vulnerable programs, encouraged--but did not require--its components and activities to review those programs they considered highly vulnerable but which were not ranked highly vulnerable Navy-wide. For example, the Headquarters of the Commander-in-Chief of the Pacific Fleet ranked administrative support as its most highly vulnerable area in June 1982. As of October 15, 1983, it had not performed internal control reviews in this area. The three areas it had reviewed were financial, supply, and transportation, each ranked low by the component but high Navy-wide. We believe reviews should be required in the local high vulnerability program areas because management attitude, organizational structure, personnel, organizational checks and balances, and safeguards are all local factors which heavily influence the vulnerability of a program area.

--The Air Force report to the Secretary of Defense, while generally outlining areas of concern, does not specifically address the problems or material weaknesses. For example, foreign military sales financial management is listed as a "material weakness," but the Air Force report

does not identify what the specific problems are, implying that the entire subject area is materially weak. Unless specific problems and, if known, the associated internal control weaknesses are identified, neither the Air Force, the Office of the Secretary of Defense, nor the Congress can effectively measure the successful resolution of the problems.

In discussing these problems with Defense officials, we found that action is planned or underway that should significantly improve the implementation process. A revision to the internal control directive (DOD Directive 7040.6) has been drafted by DOD officials. This directive will require all reporting centers to base their annual reports to the Secretary of Defense on evaluations made in accordance with OMB guidelines and will specify that documentation serves as a reference for managers reviewing management controls. DOD officials recognize the need for agencywide consistency in implementing the act and are considering use of a contractor-developed course for training lower level managers. Each of the reporting centers will be expected to provide training for middle and upper level managers.

In addition, DOD officials also recognize a problem with the inconsistency in holding managers responsible for internal controls through performance appraisals. They are presently working with OMB to define what would be appropriate in this regard.

ACCOUNTING SYSTEMS COMPLIANCE

DOD initiated a limited effort to report on accounting systems compliance with the Comptroller General's accounting principles and standards. We found that the military departments and the Defense Logistics Agency made determinations on compliance, based on the experience, knowledge, and observations of accounting officials rather than on evaluations specifically designed to assess how well systems operated. According to a DOD official, DOD took this approach because of time constraints and the fact that the accounting officials who made the determinations had firsthand knowledge of the systems. The Defense Mapping Agency based its report on the determinations made by the Air Force because it uses the Air Force's accounting systems software.

In this regard, we noted that the Defense Mapping Agency drafted new internal control guidance to incorporate the identification and evaluation of the manual processing functions

supporting their automated accounting systems. This guidance requires responsible managers to certify that the software has not been altered by their operators. If the software has been altered, they must submit a statement on the results of testing the accounting system changes for conformance with the Comptroller General's accounting principles and standards.

For future years, we believe additional work is necessary to form a better basis for concluding whether accounting systems are in conformance with the Comptroller General's accounting principles and standards. DOD officials recognize that more guidance and oversight is necessary. For this purpose, additional DOD guidance will include assigning responsibilities for documenting accounting system designs, testing systems in operation, and tracking reported accounting system problems.

THE SECRETARY OF
DEFENSE'S ANNUAL STATEMENT

DOD reported broad areas in which internal control weaknesses had been corrected or corrective actions were required. In addition, accounting system deficiencies were reported. The areas of internal control weakness were:

- | | |
|--------------------------|----------------------------------|
| --Cash Management | --Information Systems Management |
| --Cash/Debt Management | --Procurement |
| --Financial Management | --Property Management |
| --Foreign Military Sales | --Security |

Appendix II provides additional information on these areas.

DOD stated that corrective actions had been taken on some weaknesses. For example, it reported that actions were taken to ensure compliance with existing regulations that would correct identified weaknesses in conducting inventories; reporting missing, lost, or stolen property; and reconciling physical inventories to records. In another example, DOD reported that linking Army disbursing stations with the Security Assistance Accounting Center's centralized accounting system improved controls over monies disbursed from the Foreign Military Sales Trust Fund.

DOD reported other weaknesses in areas still needing improvement which included procurement, cash/debt management, and security. DOD also reported that in addition to establishing corrective action plans and schedules for each of the areas, it also plans to control and track these weaknesses until corrective actions are completed.

The section of the DOD report covering compliance with the Comptroller General's accounting principles and standards included major areas of deficiencies, a listing of 154 accounting systems or system segments in broad compliance/noncompliance categories, and milestone dates for bringing 98 noncomplying systems or system segments into compliance. The remaining 56 accounting systems or system segments were deemed to be in compliance.

One or more of the reported major areas of deficiencies resulted in the 98 systems or system segments not complying with the Comptroller General's principles and standards. These areas include: general ledger control and reporting, property accounting, cost accounting, accrual accounting, military pay entitlements, in-transit property accountability, timeliness, systems documentation, and interfaces between accounting system segments.

TRACKING AND FOLLOW-UP SYSTEMS

The Financial Integrity Act has two important purposes: (1) to promote effective internal accounting and administrative controls and (2) to conform agency accounting systems to the principles, standards, and related requirements prescribed by the Comptroller General. The identification of internal control weaknesses and accounting system conformance problems is essential to the achievement of these purposes. The identification, however, is only the beginning--we believe corrective action is the heart of the program.

DOD's draft revision to Directive 7040.6 requires reporting centers to establish a formal follow-up system to record and track (1) deficiencies disclosed by any source, (2) scheduled corrective actions, and (3) established completion dates for these corrective actions.

The reporting centers we visited have developed or are in the process of developing such systems. The Defense Mapping Agency has a system in place; the Departments of the Army, Navy, and Air Force are developing systems. The Defense Logistics Agency has assigned this responsibility to its components, but plans to incorporate such a system into its audit follow-up system in 1984.

According to an official of the Office of the Assistant Secretary of Defense (Comptroller), DOD does not plan to establish a separate, DOD-wide follow-up system for Financial Integrity Act purposes. Instead, as the Department's draft

revision to Directive 7040.6 states, reporting centers are given the responsibility to establish individual follow-up systems. The official pointed out that this requirement is consistent with DOD's decentralized approach to management. It was further pointed out that the centers were encouraged, but not required, to incorporate the Financial Integrity Act follow-up system into existing audit report follow-up systems.

We believe the internal reporting process used to prepare the Secretary's annual statement lends itself to an effective follow-up system. Throughout the large, complex military organization, each level receives reports from subordinate levels, consolidates them, and reports internal control and accounting system compliance problems to the next higher level. In this way, the Secretary's statement is prepared. This process results in each higher level having a list of the problems reported at the immediate subordinate level. This system gives the necessary information and could be used in reverse for follow up to ensure that actions are taken.

We believe it is essential that DOD establish an effective system to (1) track identified internal control and accounting system problems and (2) follow up to see that corrective actions are taken. We strongly encourage continuation of DOD's effort to have reporting centers develop follow-up systems. Because of this effort, we are not making a recommendation at this time. We plan, however, to closely monitor progress in this area as we continue our work in 1984.

OBJECTIVES, SCOPE, AND METHODOLOGY

The overall objective of our review was to evaluate DOD's implementation of the Financial Integrity Act. Because our first-year review was limited to an evaluation of the implementation process, we did not attempt to independently determine the status of DOD's internal control systems or the extent to which DOD's accounting systems comply with the Comptroller General's principles and standards. To accomplish our objective, we reviewed relevant DOD directives and correspondence, and interviewed appropriate officials in the offices of the Assistant Secretary of Defense (Comptroller) and the Inspector General. We also did work at 5 of DOD's 24 internal control reporting centers.

--Department of the Army.

--Department of the Navy.

APPENDIX I

APPENDIX I

- Department of the Air Force.
- The Defense Logistics Agency.
- The Defense Mapping Agency.

These centers were selected because they provide broad coverage of operating and support activities in the Department. Details on the activities visited and the specific work done are contained in our reports to center heads. Our reviews were conducted between July 1983 and March 1984.

Because the act requires executive agencies to use OMB guidelines to evaluate systems of internal accounting and administrative control, we also used them to evaluate DOD's efforts. We recognize that a large part of these efforts were completed or underway when OMB issued its guidelines.

Our review was conducted in accordance with generally accepted government auditing standards.

DOD'S AREAS OF WEAKNESS REPORTEDWHERE CORRECTIVE ACTIONS HAVE BEEN TAKEN

<u>Area</u>	<u>Reported Corrective Action</u>
Property Management	"Property managers and auditors identified some practices which deviated from existing policy and regulations. Actions taken to correct these deficiencies resulted in improved controls to identify precious metals; reduced potential for the loss of weapons, ammunition, and narcotics; and increased accuracy of inventory records over plant property, small tools, and ground support equipment."
Financial Management	"Financial managers effected savings in transportation costs by refining a number of procedures for establishing delivery dates for shipments of material; in retirement costs by identifying unreported deceased retirees and beneficiaries; and in civil service retirement accounts by improving the accuracy of reports to the Office of Personnel Management."
Cash Management	"Cash management personnel reduced to minimum levels the balances at finance offices and modified deposit procedures to expedite the flow of funds to the U.S. Treasury."
Foreign Military Sales	"Foreign Military Sales (FMS) managers in one DOD component established a system to improve control over trust fund disbursements."
Information Systems Management	"Managers of information systems documented security requirements, established new emergency procedures, and arrived at less

expensive alternatives to contingency plans for providing continuity of the data processing operation."

REQUIRING CORRECTIVE ACTIONS

<u>Area</u>	<u>Required Corrective Action</u>
Foreign Military Sales	"There is a need for improved management to assure that all sales are made in accordance with the provisions of the Arms Export Control Act and that there is adequate control over and accounting for U.S. resources and customer funds."
Procurement	"Procurement managers must increase competition; expand sources of supply; improve methods for spare parts procurement; reduce cost growth in weapon systems; and address changes, more effectively, in small computer technology."
Property Management	"The administrative and accounting controls over property need to be strengthened. Lack of these controls has adversely impacted the management of all property whether held by DOD or furnished to contractors. DOD has issued property accounting standards. When properly implemented, these standards will establish financial control over these assets."
Cash/Debt Management	"Financial managers must improve controls to assure that payments are made more timely (not early or late), erroneous payments are avoided, receivables are promptly recorded and collected, receipts are deposited in a timely manner, and cash held outside the Treasury is minimal."

Security

"Security managers need to complete the evaluation of the overall security management process, as well as particular areas of policy and procedures in order to put in place effective ways for organizing the program and controlling access to resources (e.g., cash, tangible property, technology, computers/automation equipment, and data)."

GAO REPORTS ON DOD'S FIRST-YEAR IMPLEMENTATION
OF THE FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT

<u>Title</u>	<u>Date</u>	<u>Report number</u>
Department of the Army's First-Year Implementation of the Federal Managers' Financial Integrity Act	May 1, 1984	GAO/NSIAD-84-92
Department of the Navy's First-Year Implementation of the Federal Managers' Financial Integrity Act	May 1, 1984	GAO/NSIAD-84-94
Department of the Air Force's First-Year Implementation of the Federal Managers' Financial Integrity Act	May 1, 1984	GAO/NSIAD-84-93
Defense Logistics Agency's First-Year Implementation of the Federal Managers' Financial Integrity Act	May 1, 1984	GAO/NSIAD-84-99
Defense Mapping Agency's First-Year Implementation of the Federal Managers' Financial Integrity Act	May 1, 1984	GAO/NSIAD-84-101



COMPTROLLER

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

27 MAR 1984

Mr. Frank C. Conahan
Director, National Security
and International Affairs
Division
General Accounting Office
441 G Street, NW, Room 4804
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report, "The Department of Defense's First Year Implementation of the Federal Managers' Financial Integrity Act (OSD)," dated March 12, 1984 (GAO Code No. 390003), OSD Case No. 6465.

DoD has made steady progress and has dedicated significant resources to implementing the Financial Integrity Act since its enactment in September 1982. The Department expects to show continued progress and improvement in 1984. The GAO reviews have provided DoD with the opportunity to assess its progress to date and to focus attention on those activities where emphasis is needed to further institutionalize the program. It is also appreciated that your staff recognized that the DoD has implemented several initiatives which will resolve the concerns noted in the Draft Report.

DoD is presently in the process of reissuing DoD Directive 7040.6 on this program and anticipates publication by April 30, 1984. The Directive has been revised to better define an assessable unit, require the establishment of quality control programs, require management control responsibilities to be included in military and civilian position descriptions, and include nonappropriated fund instrumentalities, e.g., the Army and Air Force Exchange Service (AAFES), in the management control program as a matter of DoD policy. The DoD Directive will provide uniform policy and procedures for improved management control of resources within DoD.

The Secretary reported in his Integrity Act Annual Statement to the President and the Congress that one major difficulty encountered during the first year of the program was the lack of a standardized training program. Several of the GAO concerns, e.g., the uneven quality, inconsistency, and inadequacy in performing vulnerability assessments and management control reviews, also addressed this need. At the present time, a contractor is developing a DoD handbook for performing vulnerability assessments and management control reviews which will describe what steps are

to be followed, why the step is important, and how to do each step. This handbook should provide a baseline for measuring quality and consistency among the Components and for developing a quality control program. The handbook is expected to be available in July/August 1984.

The DoD Accounting Manual is also being revised to provide additional guidance on the maintenance of documentation, and the testing and approval of accounting systems. This new guidance, coupled with the resources we are applying to monitor DoD Component accounting systems, should contribute to continued progress in our efforts to bring all DoD accounting systems into full compliance with Comptroller General accounting principles, standards and related requirements.

DoD comments on each of the GAO findings and recommendation are in the Enclosure. Thank you for providing DoD with an opportunity to comment on this Draft Report.

Sincerely,



John R. Quetsch
Principal Deputy Assistant Secretary of Defense
(Comptroller)

Enclosure

DoD Comments

on

GAO Draft Report, "The Department of Defense's First Year Implementation of the Federal Managers' Financial Integrity Act (OSD)," dated March 12, 1984 (GAO Code No. 390003), OSD Case No. 6465

GAO FINDING A

Early department-wide guidance for making vulnerability assessments includes about half the factors subsequently prescribed by the Office of Management and Budget (OMB). (p. 2, Draft Report) (See app.I, p. 4, this report.)

DoD COMMENT

Concur. The initial DoD guidance complied with the substance of the original OMB requirements. In DoD, vulnerability assessments were required to be completed by July 31, 1982, which was almost six months before the OMB Guidelines were available. A revised DoD Directive 7040.6 and a comprehensive DoD training program will incorporate the mandatory OMB Guidelines requirements for making a vulnerability assessment. The Directive should be available in April and the training program in July or August 1984.

GAO FINDING B

Persons involved in the internal control process at the five centers reviewed need additional and/or better training. (p. 3, Draft Report) (See app. I, p. 4, this report.)

DoD COMMENT

Concur. Most DoD Components did provide and are continuing to provide interim training to their staffs. As previously mentioned, additional and better training is being developed. It will include a comprehensive "how-to-do" package.

GAO FINDING C

Some reporting centers did not include all elements when dividing into assessable units. (p. 3, Draft Report) (See app. I, p. 4, this report.)

DoD COMMENT

Concur. DoD is reissuing the Directive on this program. It will include a requirement for each DoD organization head to establish an inventory of assessable units by segmenting each activity into its organizational units and identifying within each organizational unit all the functions it performs.

NOTE: Page numbers have been added to correspond to this report.

GAO FINDING D

Problems were encountered with vulnerability assessments. Generally, the vulnerability assessments were either inadequately performed or done inconsistently within the centers. (p. 3, Draft Report) (See app. I, p. 5, this report.)

DoD COMMENT

Concur. The revised DoD Directive and training program, as well as the current emphasis placed on performing vulnerability assessments by individual DoD Components, should minimize any future problems.

GAO FINDING E

Generally, documentation of vulnerability assessments and internal control reviews was inadequate and inconsistent. (p. 3, Draft Report) (See app. I, p. 5, this report.)

DoD COMMENT

Concur. The DoD initiatives outlined in response to Finding A will specify documentation requirements, and will provide a baseline for measuring consistency among the DoD Components.

GAO FINDING F

All centers reviewed had problems concerning automated data processing (ADP) general and application controls in their evaluations. (p. 3, Draft Report) (See app. I, p. 5, this report.)

DoD COMMENT

Concur. DoD will form a working group to develop a guideline document on how ADP management control reviews should be accomplished. The working group will address both ADP application and general controls and develop a process to coordinate the evaluation of standard (multi-site) systems. The working group should be established by May 31, 1984.

GAO FINDING G

The Navy encouraged, but did not require, its components and activities to review those programs they considered highly vulnerable, but which were not ranked highly vulnerable Navy-wide. (p. 4, Draft Report) (See app. I, p. 6, this report.)

DoD COMMENT

Concur. The Secretary of the Navy (SECNAV) will revise his guidance by May 1984, to require Department of Navy activities to review highly vulnerable areas at the local level. This requirement will also be incorporated into a revision of SECNAV

Instruction 5200.35, which will be promulgated after the April 30, 1984, issuance of the DoD Directive.

GAO FINDING H

The Air Force report to the Secretary of Defense, while generally outlining areas of concern, does not specifically address the problems or the material weaknesses. (p. 4, Draft Report) (See app. I, p. 6, this report.)

DoD COMMENT

Concur. On March 14, 1984, the Acting Assistant Secretary of the Air Force (Financial Management) directed that the Fiscal Year 1984 annual statement not only identify material weaknesses but also explain the problems associated with such weaknesses and the planned corrective actions. DoD will also provide more definite guidance and instructions to Components at the appropriate time regarding the submission of their annual statements for Fiscal Year 1984.

GAO RECOMMENDATION

In regard to the Army and Air Force Exchange Service (AAFES), it is appropriate and desirable for the Secretary of Defense to require this activity to follow the provisions of the Financial Integrity Act regardless of whether legally required. Therefore, we recommend that, as a matter of policy, you (1) direct AAFES to follow the provisions of the Act, and (2) assign permanent responsibility for the Exchange Service's internal control evaluation process to either the Secretary of the Army or the Secretary of the Air Force. This responsibility should include implementing the Act, reporting internal control weaknesses, and following up on corrective actions. (p. 5, Draft Report) (See app. I, p. 6, this report.)

DoD COMMENT

Concur. DoD will take the following implementing actions:

a. DoD Directive 7040.6, implementing the Federal Managers' Financial Integrity Act will include nonappropriated fund instrumentalities as a matter of policy. It is anticipated that this revised Directive will become effective April 30, 1984.

b. The responsibility for AAFES will remain with the Air Force until August 1985 for purposes of consistency of reporting. On March 21, 1984, the Assistant Secretary of Defense (MI&L) requested the Secretaries of the Army and Air Force to make a permanent assignment of responsibility for the purpose of fulfilling the requirements of the Directive.

GLOSSARY

The following definitions were developed by GAO for our review of the implementation of the Federal Managers' Financial Integrity Act.

Accounting System

The total structure of the methods and procedures used to record, classify, and report information on the financial position and operations of a governmental unit or any of its funds, or organizational components. An accounting system should assist in the financial management functions of budget formulation and execution, proprietary accounting and financial reporting.

Administrative Function

An activity in an agency which is carried out to support the accomplishment of an agency's programs, missions, or objectives. These activities may include ADP, travel, or consulting services. However, there is no uniform definition of administrative functions; each agency's may be unique.

ADP Application Controls

Controls that are unique to each software application system. Application controls are intended to assure the quality of data origination, input, processing, and output.

ADP General Controls

Controls that apply to the overall management of the ADP function in an agency. General ADP controls have a direct effect on the quality of service rendered to ADP users and cover the processing of all ADP application systems. These controls affect most ADP hardware and application software systems, and include

- organizational controls for the ADP unit;
- system design, development, and modification controls;
- data center management controls;
- data center security controls;
- system software controls; and
- hardware controls.

These controls should be evaluated by ADP managers as part of an analysis of the general control environment.

Agency Component

A major organization, program, or functional subdivision of an agency having one or more separate systems of internal control, and a specific, responsible manager.

Assessable Unit

A program or administrative function or subdivision thereof, which is to be the subject of a vulnerability assessment. An agency should identify its assessable units in such a way as to (1) include the entire agency and (2) facilitate meaningful vulnerability assessments. All agency program or administrative functions must be assessed, with the exception of those involved in the performance of policymaking or statutory formulation.

Audit Resolution

Begins when auditors report their findings to management and completed only after management takes action. Management must either correct identified deficiencies, produce improvements, or demonstrate that findings are invalid. "Audit Resolution" is one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Control Objective

A desired goal or condition for a specific event cycle, system, or subsystem. An agency's control objectives should be developed for each agency activity and should address the three objectives in the Federal Managers' Financial Integrity Act. An example of a control objective may be "Paychecks should be issued to all, and only, entitled persons." "Control Objectives" are one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Control Technique

Any mechanism relied on to efficiently and effectively accomplish a control objective. These mechanisms, if operating as intended, help prevent fraud, waste, abuse, or mismanagement. An example of a control technique might be the comparison of automated personnel and payroll master files prior to computing and issuing paychecks. "Control Techniques" are one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Documentation

That information which would allow an independent reviewer to reach the same conclusions as the original reviewer regarding an agency's internal controls; and the methods used, personnel involved, and conclusions reached in conducting its internal control evaluation, improvement, and reporting process. This information should be current and be available for review. "Documentation" of internal controls is one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Event Cycle

A grouping of similar activities. An entity's activities can be grouped into a discrete number of cycles. These groupings are based on what is accomplished, and therefore facilitate the identification of cycle objectives. For example, most agencies will have a disbursement cycle which will include all events contributing to the objective of providing reasonable assurance that all payments are legal, proper, accurate, and timely.

General Control Environment

Those environmental factors that can influence the effectiveness of internal controls over program and administrative functions. An evaluation of the general control environment is the first step in the vulnerability assessment process required by OMB's Guidelines.

This evaluation may be performed for the component as a whole, or individually for each program and administrative function within the component. The determining factors would be the size, nature, and degree of centralization of the programs and functions conducted within the agency component.

Inherent Risk

The inherent potential for waste, loss, unauthorized use, or misappropriation due to the nature of an activity itself. An analysis of each assessable unit's inherent risk is the second step in the vulnerability assessment process required by OMB's Guidelines. OMB's Guidelines suggest that the matters to be considered in the analysis should include, but need not be limited to, the following: purpose and characteristics, budget level, impact outside the agency, age and life expectancy, degree of centralization, special concerns, prior reviews, and management responsiveness.

Internal Controls

The plan of organization and all coordinate methods and measures adopted by an agency to provide reasonable assurance that the three objectives of the Federal Managers' Financial Integrity Act of 1982 are achieved. Internal controls should be established in accordance with the Comptroller General's Internal Control Standards. Typically, an internal control represents the combination of a control objective, along with a control technique (or set of techniques) which are being relied on to achieve that control objective.

Internal Control Review

A detailed examination of a system of internal control to determine whether adequate control measures exist and are implemented to prevent or detect the occurrence of potential risks in a cost effective manner. OMB's Guidelines recommend six steps for an internal control review: (1) identification of the event cycle, (2) analysis of the general control environment, (3) documentation of the event cycle, (4) evaluation of internal controls within the cycle, (5) testing of the internal controls, and (6) reporting the results. Internal control reviews should normally be conducted for those areas rated as highly vulnerable in the vulnerability assessment process, where corrective action is not readily apparent. An agency should allocate resources for these detailed reviews of internal control based on vulnerability; those most vulnerable should be reviewed first.

Internal Control Standards

In 1983, the Comptroller General issued a set of Standards For Internal Controls In The Federal Government. The Federal Managers' Financial Integrity Act of 1982 requires each executive agency to establish internal accounting and administrative controls in accordance with these standards. There are five general standards, six specific standards, and one audit resolution standard. The five general standards are: (1) reasonable assurance, (2) supportive attitude, (3) competent personnel, (4) control objectives, and (5) control techniques. The six specific standards are: (1) documentation, (2) recording of transactions and events, (3) execution of transactions and events, (4) separation of duties, (5) supervision, and (6) access to and accountability for resources.

OMB Guidelines

The document issued by the Office of Management and Budget in December 1982, Guidelines for the Evaluation and Improvement of and Reporting on Internal Control Systems in the Federal Government. An evaluation conducted in accordance with these guidelines is to provide a basis for an agency's annual statement required by the act.

Preliminary Evaluation of Safeguards

A judgment regarding the existence and adequacy of internal control over an assessable unit. This evaluation is the third step in the vulnerability assessment process required by the OMB Guidelines. The evaluation is preliminary, in that a more in-depth review of internal controls is the focus of the internal control review phase. The preliminary evaluation of controls required here should be based largely on the evaluator's working knowledge of the existence and functioning of internal controls in the subject assessable unit.

Program

Generally, an organized set of activities directed toward a common purpose or goal, and undertaken or proposed by an agency in order to carry out its responsibilities. In practice, however, the term "program" has many meanings. It is used to describe the agency's mission, functions, activities, services, projects, and processes.

Reasonable Assurance

Internal control systems should provide reasonable, but not absolute, assurance that the objectives of the system will be accomplished. This concept recognizes that the cost of internal control should not exceed the benefit expected to be derived therefrom, and that the benefits consist of reductions in the risks of failing to achieve stated objectives. Estimates and judgments are required to assess the expected benefits and related costs of internal controls. Errors or irregularities may occur and not be detected because of inherent limitations in any internal control, including those resulting from resource constraints, or congressional restrictions. "Reasonable Assurance" is one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Segmentation

The process by which an agency identifies its assessable units; i.e., its programs and administrative functions. The inventory of assessable units developed as a result of this process must be appropriately detailed so as to provide a basis for the conduct of meaningful vulnerability assessments. The OMB Guidelines provide that all the agency activities, except those concerned with policymaking, should be included in the inventory.

There is no single best method to segment an agency, particularly in light of variations in agency organization structure and responsibilities.

Specific Risk

A judgment regarding the likelihood and magnitude of error or irregularity in the event cycle being evaluated. These judgments represent an essential element of the fourth step recommended by OMB in its Guidelines for an internal control review: "Evaluation of the internal controls within the event cycle." The judgment regarding specific risk is based on a comparison of control objectives with related control techniques. Based on this evaluation, the amount and type of control testing, OMB's fifth step in an internal control review, will be determined.

Testing

The examination of available evidence to determine whether internal controls are functioning as intended. Testing is the fifth step recommended in OMB's Guidelines for the performance of an internal control review.

The nature of the controls, the significance of the cycle, importance of control objective, the nature of the specific risks, possible compensating controls, testing resources, and timing must all be considered in developing appropriate tests. Generally, testing can be categorized as either "compliance" or "substantive." Compliance testing is generally used when the judgment regarding specific risk has given reason to rely on a control technique. It is designed to verify if one or more internal control techniques are operating. The other category of testing, "substantive" testing, is used when the specific risk is sufficiently great that the control cannot be relied on. A substantive test is designed not to verify the operation of a control technique but rather to verify the results of the process to which the control was applied.

Vulnerability Assessment

A biennial review of the susceptibility of an assessable unit to the occurrence of waste, loss, unauthorized use, or misappropriation. OMB's Guidelines prescribe three basic steps for the conduct of vulnerability assessment: (1) analyze the general control environment, (2) analyze the inherent risk, and (3) perform a preliminary evaluation of existing safeguards.

The primary purpose of vulnerability assessments is to determine if and in what sequence resources should be allocated for the performance of internal control reviews.

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